BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
CRG Holdings, Inc., formerly	)	No. 92R-0838
Charles of the Ritz Group Ltd.	)	

Representing the Parties:

For Appellant: James P. Kleier, Attorney

For Respondent: Kathleen A. Andleman, Counsel

Counsel for Board of Equalization: Derick J. Brannan, Tax Counsel

O P I N I O N

Appellant filed this appeal pursuant to former section 26075, subdivision (a), of the Revenue and Taxation Code (renumbered as section 19324, subdivision (a), operative January 1, 1994) from the action of the Franchise Tax Board in denying the claim of CRG Holdings, Inc., formerly Charles of the Ritz Group, Ltd., for a refund of franchise tax in the amount of $433,613 for the income year ended December 31, 1986.

The Board decided most of the issues attendant to this appeal at the conclusion of its calendar of hearings on December 4, 1996.[1] Therefore, the only issue remaining on appeal is whether appellant is entitled to an adjustment to its basis in the stock of its subsidiaries based on a consent dividend properly declared pursuant to the Internal Revenue Code (IRC). For the reasons set forth below, we choose not to recognize such a dividend for purposes of California law.

I. Factual Background:

Appellant owned and controlled numerous fragrance and cosmetics subsidiaries,[2] including both foreign and domestic corporations. In 1985, appellant declared a consent dividend from its foreign subsidiaries in accordance with Internal Revenue Code (IRC) section 565. Under the consent dividend procedure no money is transferred, but the Internal Revenue Service (IRS) treats such a dividend as if appellant received a cash dividend from its subsidiaries and then contributed the same money back to those subsidiaries as paid in capital; appellant's consent dividend therefore increased its basis in the subsidiary stock for federal tax purposes. (I.R.C. § 565(c); Treas. Reg. § 1.565-3(a) (1989).) California does not expressly recognize such a consent dividend.

Sometime after declaring the consent dividend, appellant transferred all of its foreign subsidiary stock to the CRGL Holding Company (the Holding Company[3]). On December 29, 1986, Yves Saint Laurent, SA (YSL), purchased the foreign subsidiary stock from the Holding Company. Because of the 1985 consent dividend and the corresponding increase in its foreign stock basis at the federal level, appellant recognized less gain on the sale of the foreign stock for federal tax purposes than it did for state tax purposes.

On behalf of its parent corporation, appellant initially filed a worldwide combined report for the domestic and foreign cosmetic operations (including the Holding Company) for the income year ended December 31, 1986.[4] On February 3, 1988, appellant filed an amended 1986 return seeking a refund of $433,613; the bulk of the claim relied on the proposition that California should recognize the consent dividend and allow a corresponding adjustment to appellant's basis in the foreign subsidiary stock.

II. Discussion:

The California Revenue and Taxation Code incorporates various provisions of the IRC pertaining to dividends and corporate basis. (See, e.g., Rev. & Tax. Code, § 24451.) However, and as acknowledged by appellant, the California Legislature has not adopted the federal consent dividend statute. Nonetheless, appellant argues that the consent dividend is consistent with other provisions of the

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[1] Immediately following the hearing, we determined that this Board had jurisdiction to hear appellant's case, that appellant and its holding company were unitary, that the proceeds from the sale of the stock held by its holding company constituted business income and that such proceeds should not be included in the denominator of the sales factor when determining appellant's California apportionment factor.

[2] Cosmetics and fragrances are apparently distinct product lines, but for ease of reference, this opinion will refer to them collectively as cosmetics.

[3] Shortly after the income year ended December 31, 1986, appellant changed its name from Charles of the Ritz Group Ltd., to its current name, CRG Holdings, Inc.

[4] Appellant's parent, Squibb Corporation, filed a separate worldwide combined report for its pharmaceutical operations; respondent had accepted this "line of business" reporting for roughly twenty years.

IRC previously adopted by the state legislature and urges this Board to recognize such a dividend under state law.[5] Unfortunately, appellant offers no legal authority which encourages us to adopt the consent dividend, nor does appellant offer any evidence that the legislature intended to incorporate the consent dividend procedure into California law.

Our Board is charged with interpreting the law as enacted by the Legislature, we do not have authority to change that law, nor to assume the existence of laws which do not exist. (See Appeal of Chester A. Rowland, Cal. St. Bd. of Equal., Oct. 21, 1975.) Appellant may believe that the failure of the California Revenue and Taxation Code to recognize a consent dividend imposes an unfair economic burden; however, such concerns should be directed to the legislature rather than this Board. (Appeal of Terry A. and Jeanne M. Burdyshaw, Cal. St. Bd. of Equal., Feb. 8, 1979.) For these reasons alone, we would be reluctant to depart from the express provisions of the Revenue and Taxation Code.

However, we need not blindly resort to this Board's limited mandate in order to arrive at a decision in this case. There are a number of additional reasons that we decline to incorporate the consent dividend concept into our state law. The first is illustrated by a brief review of the purpose behind the federal consent dividend statute. Its purpose is,

> "to provide a method whereby such a corporation, with the cooperation of its shareholder, may obtain the tax benefit incident to [an] actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders."

(H.R. No. 1860, 75th Cong., 3rd Sess. (1937) p. 24, discussing the predecessor to I.R.C. § 565; see also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (6th ed., 1996) ¶ 7.09[2][b], p. 7-38.) Such an occasion may arise when the taxpayer would otherwise be subject to the federal accumulated earnings tax or may not have the liquid assets necessary to declare a cash dividend. (See I.R.C. § 531 et. seq.) A taxpayer might also choose a consent dividend as a means to avoid foreign taxes incident to a more traditional dividend.

None of these scenarios are particularly compelling for purposes of the California Franchise Tax. First, California does not have an accumulated earnings tax. Second, a taxpayer's choice to place its money in liquid or illiquid assets, and thereby impact its ability to pay dividends, should not become the state's concern for tax purposes. Finally, foreign taxes are akin to federal taxes in that they occur at a different level than the state tax; any related policy considerations should be, and when appropriate are, implemented at that level.

Appellant also argues that California should recognize the consent dividend to avoid double taxation of the income from its foreign subsidiaries. More specifically, appellant argues that the

[5]Appellant suggests that it may accomplish the same result as a consent dividend if its subsidiary declares an actual dividend, and then appellant contributes the cash dividend as paid in capital. Were those facts before this Board, we might very well reach that outcome. However, we must decide the facts of the instant case and not a hypothetical scenario proposed by appellant.

first tax occurs when the subsidiary income is included in the California apportionment formula as income of the unitary group, and that the second tax occurs when appellant sells the subsidiary stock for an increased purchase price which reflects the undistributed earnings and profits attributable to that income. (See also Goldman, Brown and Farrell, 1130 T.M., Income Taxes: Consolidated Returns and Combined Reporting, pp. 20-23.)

Appellant suggests that the State of California does not condone double taxation in the unitary context. (Rosemary Properties, Inc. v. McColgan (1947) 29 Cal.2d 677, 683; Burton E. Green Investment Co. v. McColgan (1943) 60 Cal.App.2d 224, 231-233; FTB LR 376, Nov. 19, 1974.) Furthermore, according to appellant, double taxation was specifically disapproved by at least two of this Board's prior decisions. (Appeals of Safeway Stores, Inc., Cal. St. Bd. of Equal., Mar. 2, 1962; Appeal of Signal Companies, Inc., Cal. St. Bd. of Equal., Nov. 19, 1986, Appeal No. 79A-438-MW (Signal I).[6])

While the instant scenario may potentially result in some element of double taxation,[7] the California Legislature has not enacted any statute designed to alleviate the alleged impropriety[8] by way of a consent dividend statute. In contrast, the Legislature has enacted at least two statutes designed in part to alleviate the potential for double taxation at the corporate level. Section 24402 (formerly section 8, subdivision (h)) allows a corporation to deduct, "[a] portion of dividends received during the income year declared from income which has previously been included in the measure of the taxes." (Rev. & Tax. Code, § 24402, subd. (a).) That section purports to avoid the inclusion of the same income in the measure of tax to be paid by two different taxpayers. (Burton E. Green, supra, at pp. 231-233.) Section 25106 is specifically directed at the unitary apportionment process and eliminates from income intercorporate dividends paid from one member of a unitary group to another. (Rev. & Tax. Code, § 25106.) That section is intended "to avoid counting the same income twice in computing the income of a multicorporate unitary business." (Appeal of Louisiana-Pacific Corp., 87-SBE-005, Jan. 6, 1987.) Both section 24402 and section 25106 demonstrate the Legislature's awareness of the double taxation issue. Just as significantly, the presence of these two statutes, and the corresponding absence of a consent dividend provision, most likely reflect a Legislative decision not to enact a consent dividend statute as a means to remedy appellant's claimed double taxation.

The authorities cited by appellant do not enhance its position in this case. For example, both court decisions discuss the ills of double taxation in the context of dividends actually paid, and the application of certain statutory language to the source of those dividends. (Rosemary Properties, supra, at pp. 678, 681 and 689; Burton E. Green, supra, at pp. 226 and 232.) Appellant's case presents

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[6]There were two separate opinions issued on the same day pertaining to Signal Companies, Inc. Unfortunately, there is no ready means to distinguish between the two cases for citation purposes other than by reference to the appeal number assigned by this Board. Therefore, we will refer to the first of the two decisions, Appeal No. 79A-438-MW, as Signal I, and the second, Appeal No. 85A-203-MW, as Signal II.
[7]It is not without some trepidation that we suggest the presence of the potential for a "double tax" as argued by appellant. It appears that some portion of the foreign subsidiary income is included in the measure of the tax determined pursuant to the unitary method, but it is not necessarily clear that a portion of that income is subject to double taxation. (See Safeway Stores, Inc. v. Franchise Tax Board (1970) 3 Cal.3d 745, 752.)
[8]For that matter, we are not necessarily persuaded that double taxation in the context of appellant's facts, if it does exist, is necessarily an unacceptable result. The alleged duplicate incidents of taxation occur as a result of two separate events: the first is a sale of goods, and the second is a sale of stock. Both events are traditionally taxable.

neither of these scenarios and therefore we are not persuaded as to the particular relevance of those opinions.

Appellant also cites this Board's decision in the Appeals of Safeway Stores, supra. Although we dealt with a very similar legal question in that case,[9] the subsequent passage of the Uniform Division of Income for Tax Purposes Act (UDITPA), as well as more recent case law, may have undermined the rationale for the relevant portion of that decision.[10] For those reasons, we do not believe that our decision in the Appeals of Safeway Stores, supra, provides persuasive guidance as to the instant case.[11]

Appellant also relies on this Board's opinion in Signal I. In that appeal, the taxpayer paid too much money to its subsidiary for petroleum products. Both the IRS and the Franchise Tax Board (FTB) utilized their statutory authority to reallocate intercompany transfers and thereby reduce the taxpayer's expenses for that year. (See Rev. & Tax. Code, § 24725; I.R.C. § 482.) Rather than reclaim the money from its subsidiary, the taxpayer chose to leave the excess funds with its subsidiary. The IRS treated that money as a capital contribution, resulting in a corresponding increase in the taxpayer's basis in the subsidiary. The FTB refused to allow the same treatment because the transfer did not increase the group's net income, and therefore, no adjustment was needed to avoid double taxation. In rejecting the FTB's position, the Board indicated that,

> "The basis adjustment has nothing to do with the mitigation of double taxation[.]
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> [The Board further indicated that,]
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> "We do not believe that the unitary business concept has any effect on the situation before us. . . . It has nothing to do with determining the basis of each of the individual corporate entities involved."

(Signal I, supra.) Not only was Signal I decided on an unrelated legal rationale, its facts are clearly distinguishable from the present case. Signal I concerned an actual transfer of money between a parent and its subsidiary; it did not involve an artificial dividend not recognized under California law. Further, the allocation approved in Signal I balanced a real tax effect which resulted when the taxing authorities denied a portion of the parent's deductible expenses; the same cannot be said of appellant's situation.

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[9] In this Board's decision in Safeway, respondent argued that the taxpayer should recognize less loss on its sale of subsidiary stock in order to account for the prior operating losses of those subsidiaries; in essence, respondent's argument in that case mirrored appellant's current argument. This Board declined to allow respondent's adjustments on the basis that the operating losses represented "business" losses and therefore should not be matched against the "nonbusiness" stock losses.

[10] The courts and this Board have since allowed for the proceeds from the sale of stock to constitute business income. (Times Mirror Co. v. Franchise Tax Board (1980) 102 Cal.App.3d 872, 879-881; Appeal of General Dynamics Corporation, Cal. St. Bd. of Equal., June 3, 1975.)

[11] The Board decision in the Appeals of Safeway Stores, Inc., supra, was appealed to the California Supreme Court. However, the court did not pass on the appropriateness of the basis adjustment; rather, it limited its holding to the amount of intercorporate dividends paid from income previously included in the measure of the California franchise tax pursuant to former Revenue and Taxation Code section 8, subdivision h, subsequently renumbered as section 24402. (Safeway Stores, Inc. v. Franchise Tax Board, supra.)

Finally, we note that unitary intercorporate dividends should be, "treated substantially the same as dividends from companies which [are] not part of [a] unitary group." (Pacific Tel. & Tel. Co. v. Franchise Tax Board (1972) 7 Cal.3d 544, 557, citing Safeway Stores, Inc. v. Franchise Tax Board, supra.) For obvious reasons, the absence of dividends should be treated in the same manner. Appellant's proposed solution in the unitary context runs contrary to this policy. Consider the simple case of a nonunitary parent and its wholly owned subsidiary, both doing business exclusively in California. The subsidiary's income is taxed by California when it earns income in the state and properly files a franchise tax return. If the subsidiary chooses not to pay a dividend, and the parent then sells the subsidiary, there is a potential for double taxation similar to that argued in the instant case. The unitary method does not create the potential for double taxation as alleged by plaintiff, it is appellant's choice of operating entities which creates the perceived impropriety. As we have repeatedly held, a taxpayer is generally free to choose the manner by which to structure its affairs, but once having done so, it will be bound by the consequences of that choice. (See Appeals of Thomas J. and Gerd Perkins et al., 96-SBE-010, Apr. 11, 1996; Appeal of Gene and Donna F. Young, 94-SBE-017, Dec. 14, 1994; and Appeal of Sierra Pacific Industries, 94-SBE-002, Jan. 5, 1994.)

Based on the aforementioned considerations and applicable legal authority, we choose not to recognize consent dividends for purposes of California law.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of CRG Holdings, Inc., formerly Charles of the Ritz Group, Ltd., for refund of franchise tax in the amount of $433,613 for the income year ended December 31, 1986, be and the same is hereby sustained.

Done at Sacramento, California, this 8th day of May, 1997, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Klehs, Mr. Andal, Mr. Halverson and Mr. Chiang present.

Ernest J. Dronenburg, Jr., Chairman

Johan Klehs, Member

Dean F. Andal, Member

Rex Halverson*, Member

John Chiang**, Member

*For Kathleen Connell, per Government Code section 7.9.
**Acting Member, 4th District.